

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### The American Home

Few symbols of America's culture better explain us as a nation than the home. From the early days when European settlers fled various forms of tyranny to today, the desire to come home to one's own has motivated us to work harder and perhaps to risk more. As George Bailey's father put it in *It's a Wonderful Life* when describing their small Building and Loan; "you know, George, I feel that in a small way we are doing something important. Satisfying a fundamental urge. It's deep in the race for a man to want his own roof and walls and fireplace. And we're helping him get those things in our shabby little office."

Our leaders understood this fundamental truth throughout our history. Franklin Roosevelt did when the country was reeling from the Great Depression. As part of his 1930's New Deal he created Fannie Mae to help people get mortgages. In 1970 our country was in dire trouble, inflation was in double digits, we were deeply divided over numerous issues like the war in Vietnam, generational mistrust, authority, and race. Again our leaders saw the importance of the home and sought to make it more affordable for a larger portion of the population. The 'baby boomers' were of age and wanted to start homes. Freddie Mac was started to make mortgages available and affordable to a new generation of home buyers.

Fannie Mae and Freddie Mac are now broken, and the stakes are higher than they have ever been. There are a number of contributing factors to explain their collapse; low Fed rates for a period perhaps longer than necessary contributed to an unprecedented speculative bubble in residential real estate; Wall Street's increasingly 'innovative' packaging and securitization of mortgages marketed to naive buyers; growing recklessness and greed on the part of bankers, brokers, and mortgage lenders, and finally, a virtual pass to continue from the regulatory authorities. A few months ago the music stopped and the punch bowl ran dry.

Just how important are Fannie Mae and Freddie Mac to the US home mortgage business? Foundational is an understatement. More than 70% of new home loans are bought or guaranteed by Fannie and Freddie. Fannie, Freddie and U.S. agency Ginnie Mae, accounted for 94% of home-loan securities issued in the first half of this year, up from about 50% a year earlier, as banks and other lenders have stepped away from mortgages. Fannie and Freddie account for almost half of the \$12 trillion total of mortgages in the US. To put a trillion dollars in perspective, the entire US debt now stands at \$9.6 trillion.

FOUNDATIONAL.

Warren Buffet says the "the game is over" for Fannie and Freddie to continue as independent companies, they "don't have any net worth." According to Buffett, "they were able to borrow without any of the normal restraints. They had a blank check from the federal government." They mispriced their products and "kept existing because they had the federal government behind them." A Barron's article last weekend started this week's

perhaps final loss of confidence for the duo when they suggested that a government bailout was imminent and that stockholders would likely be left penniless as a result. Fannie's stock now trades at \$4.80 down 39% from Monday, while Freddie's \$3.08 per share has fallen 47%. They are down over 90% for the year.

Numerous government officials have also weighed in on the subject of what should be done. Former Federal Reserve Chairman Alan Greenspan and Richmond Federal Reserve Bank President Jeffrey Lacker have called for the companies to be nationalized. William Poole, former head of the St. Louis Fed, said last month Freddie is technically insolvent and Fannie's fair value may be negative next quarter. Still, Treasury Secretary Paulson has not added more since announcing his unlimited credit line offered by the Congress. The market is demanding more.

Markets have had much to digest this week and the news has been mostly negative. But as the press is so good at headlining the negative, you've probably heard it all in shrill tone to exhaustion. But here's a summary nonetheless:

- Builders in the US broke ground on the fewest houses in 17 years in July.
- The 11% decrease to an annual rate of 965,000, the lowest since March 1991, followed a 1.084 million pace the prior month according to the Commerce Department
- Building permits, a sign of future construction, also fell
- The five largest U.S. homebuilders reported a combined \$1.08 billion in losses in their most recent quarters. (Far better than the banks – right?)
- A quarterly survey of banks by the Federal Reserve showed significantly tighter lending practices on mortgages
- Rates on average 30-year fixed mortgages rose to 6.37%, this week, about the highest in six years
- Prices paid to US producers in July rose 1.2%, twice the amount economists projected and increased the most in 27 years from a year earlier, as companies faced escalating energy costs
- Core producer prices that exclude fuel and food increased 0.7%, compared with a 0.2 percent gain in June
- The Conference Board's index of leading indicators fell 0.7% in July, more than triple the drop forecast by economists surveyed by Bloomberg News
- The number of Americans collecting unemployment insurance remained near a five-year high last week
- Manufacturing in the Philadelphia region shrank for a ninth straight month.
- Commodities prices rose more than they have in the past 33 years yesterday as a hedge against dollar weakness
- Today, Fannie Mae and Freddie Mac's preferred stock was downgraded to the lowest investment-grade rating by Moody's Investors Service, which said the increased likelihood of "direct support" from the US Treasury may devalue those shares

These are expected headlines during difficult times. The economy is near or in recession, but there are positive developments going on too that will improve headlines in the coming months.

- Oil at \$117.90 remains nearly 20% below its recent high of \$147.

- The dollar is up nearly 7% against a basket of major global currencies with a 1% rise today
- Russia seems finally to be pulling out of Georgia
- Bernanke may not have to raise rates given the recent stability of the dollar and the overall fall in commodity prices
- News of the Korea Development Bank considering an investment in Lehman Brothers has boosted stock prices in general and bank stocks in particular
- Lowe's Cos., the world's second-largest home-improvement retailer, yesterday said full-year profit may fall less than anticipated and larger rival Home Depot Inc. today said profit fell less than analysts estimated as customers spent their rebates

We have quite a ways to go before we climb out of this economic mess. But there are some significantly positive trends. Recent drops in oil and commodities are a very positive sign indeed. If inflation numbers begin to reverse soon that will help as well. But, perhaps the largest missing piece of the puzzle right now is a better understanding of what the government plans with Fannie and Freddie.

The American consumer is fundamental to the US economy, powering two thirds of it. Foundational to his confidence and well-being is his home. If he owns one, he must feel that he can keep it if he is going to continue spending. If he doesn't own one, the idea of a home is a very powerful motivator. He will work all the harder and produce all the more if he believes he can one day afford one.

Addressing old man Potter as he strong-armed the board of the Bailey Building and Loan in order to close his bank's last competitor, George Bailey said:

*"what'd you say just a minute ago... They, they had to wait and save their money before they even thought of a decent home. Wait! Wait for what? Until their children grow up and leave them? Until they're so old and broken-down that they... Do you know how long it takes a working man to save five thousand dollars? [\$61,000 today] Just remember this, Mr. Potter, that this rabble you're talking about... they do most of the working and paying and living and dying in this community. Well, is it too much to have them work and pay and live and die in a couple of decent rooms and a bath? Anyway, my father didn't think so. People were human beings to him, but to you, a warped, frustrated old man, they're cattle.*

In 2005, Mr. Buffett said "it would not be the end of the world" if Fannie and Freddie stopped buying new mortgages. Careful Mr. Buffett, don't want to sound like old man Potter.

Have a *Wonderful* weekend.